E-002/GR-92-1185 ORDER AFTER RECONSIDERATION

BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

Don Storm	Chair
Tom Burton	Commissioner
Marshall Johnson	Commissioner
Cynthia A. Kitlinski	Commissioner
Dee Knaak	Commissioner

In the Matter of the Application of Northern States Power Company for Authority to Increase its Rates for Electric Service in the State of Minnesota	ISSUE DATE: January 14, 1994 DOCKET NO. E-002/GR-92-1185 ORDER AFTER RECONSIDERATION

PROCEDURAL HISTORY

On September 29, 1993, the Commission issued its FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER in the above-captioned general rate case.

On October 19, 1993, the following parties filed requests for reconsideration or rehearing: Northern States Power Company (NSP or the Company), the Minnesota Department of Public Service (the Department), the Residential and Small Business Utilities Division of the Office of the Attorney General (RUD-OAG), Mankato Area Environmentalists (MAE), and the Energy Cents Coalition.

On October 29, 1993, NSP filed a Reply to Intervenor Requests for Reconsideration and Rehearing.

On October 29, 1993, the Department and the RUD-OAG filed separate replies and Minnesota Energy Consumers (MEC) filed an Answer to NSP's Request for Reconsideration.

On November 1, 1993, Metalcasters of Minnesota (Metalcasters) filed a Reply to the Request of the Minnesota Department of Public Service Concerning Mandatory Time of Day Rates.

On November 5, 1993, the Commission issued its ORDER GRANTING RECONSIDERATION, issued to allow for consideration of the merits of the parties' petitions at a later date.

On December 2, 1993, the Commission met to consider this matter.

FINDINGS AND CONCLUSIONS

This Order will discuss each issue raised by the parties for reconsideration in turn. First, the issues common to both NSP's electric and gas rate cases will appear, then the issues only raised for reconsideration in the electric rate case. Finally, the Order will address an issue requiring clarification between the two rate cases.

I. COMMON ISSUES

A. Rate of Return

1. The September 1, 1993, Order

In its original Order, the Commission determined that NSP's required return on equity (ROE) should be set at 11.0 percent. In making this determination, the Commission relied on the testimony of Department witness Dr. Luther Thompson. The Commission found that the discounted cash flow (DCF) methodology was the most appropriate one for determining the Company's required ROE, and that applying the DCF method to NSP produced a dividend yield of 6.0 percent and a growth rate of 5.0 percent. The Commission rejected the Administrative Law Judge's recommendation to add a flotation cost adjustment to the DCF result.

2. Positions of the Parties

Two parties to the case requested that the Commission reconsider its decision that the appropriate ROE for NSP is 11.0 percent. NSP argued that the Commission must adjust the ROE to a level which is more consistent with the Hope/Bluefield[1] criteria and with decisions being reached in other NSP retail rate cases. The RUD-OAG argued that the Commission should reconsider and adopt the recommendation of RUD-OAG witness Mr. Matthew Kahal, who proposed an ROE of 10.6 percent.

In its petition, NSP argued that the Commission erred in using a single method and a single witness's recommendation to determine the appropriate ROE. In addition, NSP contended that the 11.0 percent ROE is unreasonably low and is inconsistent with the requirements of Hope and Bluefield. NSP argued that if the Commission were to continue to support Dr. Thompson's recommendation, it should consider making the following corrections: the dividend yield should be averaged forward to

---

[1] The Hope and Bluefield criteria are derived from two United States Supreme Court cases frequently cited in the context of utility ratemaking, Bluefield Water Works and Improvement Co. v. P.S.C, 262 U.S. 679 (1923), and FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944). These cases contain the following guidelines for rate of return decisions:

1. The allowed rate of return should be comparable to that generally being made on investments and other business undertakings which are attended by corresponding risks and uncertainties;

2. The return should be sufficient to enable the utility to maintain its financial integrity; and

3. The return should be sufficient to attract new capital on reasonable terms.

account for first year dividend growth; the Commission should place little or no weight on volatile earnings per share growth and analysts' forecasts of short-term future growth; and the Commission should add a flotation adjustment to its ROE determination. NSP did not offer an alternative calculation for rate of return.

RUD-OAG argued that Mr. Kahal's growth analysis satisfied all of the criteria used by the Commission. According to the RUD-OAG, Mr. Kahal looked at historical information both in his earnings retention analysis and on a stand-alone basis, and he relied on current and future economic trends. Investor analyst projections from Value Line and IBES confirmed the reasonableness of his 4.4 percent - 4.5 percent growth formulation.

According to RUD-OAG, the Commission erred in rejecting Mr. Kahal's growth rate due to his use of 1992 data. The Commission had found 1992 data to be unreliable because it was based on conditions which were not expected to reoccur in the near future. RUD-OAG argued that Mr. Kahal acknowledged and discounted 1992 data, both for the Company and for the industry as a whole, in his earnings retention analysis. When performing analyses which excluded 1992 data, the results of those analyses were still below his actual growth recommendation. RUD-OAG concluded that Mr. Kahal's use of 1992 data in some of his analyses did not lower his growth estimate below that which investors require.

3. Commission Action

After reviewing the record, the Commission concludes that a more appropriate ROE for NSP is 11.47 percent. The Commission continues to find that the DCF method is the most appropriate method for determining required ROE and that the appropriate dividend yield is 6.0 percent. However, the Commission finds that its original growth determination of 5.0 percent gave too much weight to certain aberrational factors which investors are not likely to expect in the future. In addition, the Commission will reconsider and reverse its decision to not allow a flotation adjustment to compensate the Company for its equity issuance in the test year.

a. The NSP Petition

i. Adjustment of the Dividend Yield to Account for Growth

The Commission will reject the Company's suggestion to adjust the dividend yield to account for additional growth. The Department demonstrated in the record that Dr. Thompson's dividend yield already accounts for future dividend growth. In addition, RUD-OAG witness Mr. Kahal proposed a forward-averaged dividend yield of 6.0 percent, and NSP witness Mr. Pender proposed a forward-averaged dividend yield of 6.07 percent. The Commission concludes that 6.0 percent represents an appropriate expected dividend yield for NSP.

ii. Weight Placed Upon Earnings Per Share of Growth

In reviewing the growth data, the Commission finds that NSP's earnings per share have experienced little or no growth over the five years ending in 1992. Two sharp declines in earnings per share were experienced by the Company during this five year period, one due to the Commission's denial of the Company's rate increase request in its 1990 rate case, Docket E-002/GR-89-865, and one due to extremely abnormal weather in 1992. In NSP's 1992 rate case, Docket No. E-002/GR-91-001, the Commission noted the 1990 earnings decrease due to the previous rate case decision. The Commission accordingly deemphasized 1990 earnings data when determining the appropriate ROE for NSP in Docket E-002/GR-91-001.

In the final Order in this rate case, the Commission excluded 1992 earnings growth data, because that data would have reflected the earnings decrease due to abnormal 1992 weather conditions. The Commission did not, however, follow its 1992 decision and deemphasize the 1990 earnings decrease when determining the ROE. Earnings per share continues to be an important element in determining the appropriate growth rate for NSP. Dividend growth in excess of earnings per share growth cannot be maintained over the long term at constant payout ratios. All parties agreed that historical earnings per share are likely to be considered by investors when predicting a Company's growth rate.

However, the DCF formula growth rate is designed to be a long-term future growth rate. While historical growth is often a good predictor of future growth, investors tend to discount historical results which are not likely to be sustained in the future. The Commission concludes that NSP's five-year growth data should be accorded less weight in determining the appropriate DCF growth rate for NSP.

The Commission has traditionally considered five- and ten-year averages of historical growth rates when determining the appropriate DCF growth rate. This method places extra emphasis on five-year figures, since the five-year data is also included in the ten-year average. The Commission finds that an appropriate method of according less weight to the five year data in this case would be to consider only ten-year historical growth rates in the average. NSP's ten-year growth data includes periods of both high and negative growth and is likely to represent long-term, average growth expectations of investors.

NSP witness Mr. Pender proposed a DCF growth rate of 5.32 percent, based on ten-year average historical growth rates. The Commission finds that this growth rate appropriately reflects investor growth expectations for the future for NSP.

iii. Flotation Cost Adjustment

The flotation adjustment was first proposed by RUD-OAG witness Matthew I. Kahal and was supported by the Company. In his report, the Administrative Law Judge recommended that the Commission add 15 basis points to NSP's ROE to compensate the Company for flotation expenses. The ALJ concluded that this was a reasonable adjustment because NSP had issued equity during the test year. The Department did not except to the ALJ's recommendation that NSP's ROE be adjusted to reflect flotation costs.

In its September 1, 1993 Order, the Commission rejected the ALJ's recommended flotation adjustment on the grounds that NSP did not request a flotation adjustment in its ROE calculation. On rehearing, the Commission will reconsider and reverse that decision.

The record shows that the Company supported the addition of flotation costs if the Commission determined that the ROE should be calculated using the DCF method. The Company's ROE request of 12.5 percent was not directly calculated, but instead represented an estimate within a range of possible returns. Therefore, it would not have been appropriate for the Company to add a flotation cost adjustment to the Company's request. Flotation costs should have been implicitly considered when selecting the appropriate point within the range.

However, the calculation of the dividend yield and the growth rate in the DCF method does not take flotation costs into account. In order to reflect flotation costs, a separate adjustment must be made. In the past, the Commission has adjusted ROE to reflect flotation expenses when a company is planning to issue equity in the test year. The record shows that NSP issued $100 million in equity in May of 1993. The Commission finds that it is appropriate to add a flotation cost adjustment to its DCF determination of ROE. The Commission also finds that the adjustment of 15 basis points recommended by the ALJ is reasonable.

b. The RUD-OAG Petition for Reconsideration

The Commission does not agree that it was in error in rejecting Mr. Kahal's growth rate in its original decision. Although Mr. Kahal may have excluded 1992 data in his earnings retention analysis, he included it in his historical growth data. Because the Commission has decided to place primary weight on historical growth data to determine the appropriate growth rate, its decision to reject Mr. Kahal's growth rate is reasonable.

4. Conclusion

Using the DCF method to calculate the appropriate ROE for NSP, the Commission finds that the appropriate dividend yield is 6.0 percent, the appropriate growth rate is 5.32 percent, and it is reasonable to add a flotation cost adjustment of 0.15 percent, for an ROE of 11.47 percent.

Based upon the Commission's findings and conclusions on return on equity, cost of debt and preferred stock, and capital structure herein, the Commission finds the overall rate of return for NSP in the test year to be 9.31 percent, calculated as follows:

Capital Employed	Percent	Cost	Weighted Cost
Long-term Debt	38.80 %	8.05 %	3.12 %
Short-term Debt	4.55	4.00	0.18
Preferred Stock	8.26	5.57	0.46
Common Equity	48.39 %	11.47	5.55
Total	100.00 %		9.31 %

The Commission notes that this change in the rate of return, together with the decision to apply the new federal corporate income tax legislation in calculating final rates (see infra at page 10), has the effect of altering the CCRC and the revenues to be recovered through the CCRC. Taking these changes into account, the new CCRC will be $0.00084741 and the revenues recovered using the new CCRC will be $21,239,438.

B. Incentive Compensation

In its original Order, the Commission disallowed recovery of the full amount of incentive compensation costs sought by the Company. The Commission accepted and adopted the Administrative Law Judge's findings that NSP's overall employee compensation levels were unreasonably high and that the amount by which they exceeded market medians was equal to the cost of the incentive compensation plan. Having also found significant deficiencies in the plan, the Commission took the most straightforward course of action and disallowed recovery of all incentive plan costs. The Commission will rethink this decision on reconsideration.

Having again reviewed the record and having heard the arguments of the parties on reconsideration, the Commission concludes the public interest would be better served by modifying the incentive plan than by disallowing its costs entirely.[2] First, the record shows that incentive compensation plans are widely used, respected tools for managing employee performance. The Commission expects utilities to stay abreast of management trends and experiment with promising new approaches. Penalizing the Company for implementing incentive compensation imperfectly could discourage the kind of innovative management necessary to control costs in an increasingly competitive environment.

[2] By "modifying the incentive plan" the Commission means changing the parameters of the plan as eligible for rate recovery, not requiring the Company to make changes in the plan as actually administered.

Second, the record shows that the incentive compensation plan has helped the Company reduce overall compensation costs. The Company concedes that current salary levels exceed corporate goals and that one of its purposes in introducing incentive compensation is to gradually reduce wage rates by avoiding the compounding effect of base salary increases. This strategy appears to be working; total test year labor costs were some $10 million below what they would have been had the Company been using a base-pay only system. It would be anomalous to disallow as excessive the costs of the mechanism being used to bring salaries into line with market medians.

Third, all expert testimony in the record agrees that the Commission should expect the Company to deviate slightly from compensation market medians; the only disagreement is over how much deviation is reasonable. Both compensation levels and market medians are snapshots in time; it would be more coincidental than probative if they happened to match one another exactly. The Commission concludes its original decision to limit recoverable compensation to the market median -- and the accompanying decision to disallow all incentive compensation costs as a useful proxy for the excess -- was a bit too facile.

After all, the Commission has more precise tools at its disposal than total disallowance. It can allow partial recovery of incentive compensation costs. It can disallow cost recovery for plan features it considers unreasonable. It can limit recovery of total employee compensation costs to an amount it considers reasonable, based on all the evidence in the record.

All these considerations together lead the Commission to conclude that granting partial recovery of incentive compensation expenses would be a better course than totally disallowing them. The Commission will therefore allow recovery of incentive compensation costs as outlined below.

1. Recoverable Payments Limited to 15 percent of Base Salary

The Commission continues to believe, for the reasons set forth in the original Order, that the officers' and executives' plans allow too high a proportion of these employees' total wages to come from incentive compensation. (These plans provide for incentive payments of up to 40 percent of base pay.) The Commission will limit recoverable incentive payments to 15 percent of an individual's base salary.

2. Shortfall to be Held for Ratepayers

In the original Order, the Commission expressed strong disapproval of the Company's retention of the right not to make incentive payments earned under the plan. The Commission continues to view this as an inappropriate transfer of risk from shareholders to ratepayers and as inconsistent with the test year concept on which rates are based. The Commission will therefore require the Company to record all earned but unpaid incentive compensation recoverable in rates under this Order for future return to the ratepayers. This will adequately protect ratepayers' interests and prevent erosion of the test year concept.

3. Total Amounts Recoverable Limited to 2.2 percent of Base Wages

Utilities provide essential services to captive ratepayers and must be held to a high standard of prudence and reasonableness when seeking rate recovery of any cost. In its original Order the Commission denied rate recovery of all employee compensation amounts exceeding the market median. Upon further reflection, the Commission agrees with the Administrative Law Judge, the Company, and the Department that it is more reasonable to expect and allow minor differences between actual compensation levels and market medians. Although industry averages are a good starting point for analyzing reasonableness, reasonableness depends upon the specific facts of the case before the Commission.

On the record before it in this case, the Commission agrees with the Administrative Law Judge and all parties except the Company that the 7.5 percent by which current compensation levels exceed market medians is unreasonably high. (Without conceding that current compensation is too high, the Company itself has made bringing wage levels closer to market medians a corporate priority.) The Administrative Law Judge accepted and recommended that the Commission accept the Department's position that rate recovery of compensation costs should be limited to 105 percent of the market median. This would result in authorizing recovery of incentive compensation costs equalling 2.2 percent of total Company base pay and corresponding pension costs. The Commission finds the reasoning of the Department and the Administrative Law Judge persuasive and will accept and adopt it.

4. Other Concerns Raised in Original Order

The major concerns that led to the original disallowance of incentive compensation costs have been dealt with above. The original Order also raised several less critical concerns, discussed below.

The original Order expressed disapproval of the earnings-per-share components of the executives' and officers' plans. Although the company did not expect to meet the earnings-per-share threshold in the test year and did not seek recovery of amounts attributable to meeting those goals, the Commission was concerned about appearing to concur in the plans' earnings-per-share design. Similarly, the original Order found arbitrary the plan's goal of keeping NSP rates low in comparison with the rates of other utilities, since inter-utility rate differences result from so many factors besides employee productivity. Here, too, however, the Company reports it does not expect to meet the goal in the test year and does not seek recovery of amounts attributable to meeting that goal.

These two issues have no rate impact. They did not and do not compel disallowance of cost recovery on their own. The Commission concludes development and analysis of such issues should be deferred to a proceeding in which they have a practical impact.

Finally, the Commission was originally concerned that the performance goal requiring departments to spend within 2 percent of their allocated budgets could be counterproductive or meaningless. The Commission thought the requirement would discourage cost-cutting at best and encourage frivolous spending at worst. These concerns have been allayed in part by Company explanations that departmental budgets are set after exacting inquiry; that it is Company policy to explore cost-cutting measures in the budget setting process, not the spending process; and that spending shortfalls are not encouraged because of their potential to affect quality of service. This is a plausible explanation which the Commission will not second-guess at this time.

5. Annual Report Required

The Commission will require the Company to file an annual report on the operation and performance of its incentive compensation plan. The report will include an accounting of all amounts paid under the plan, all amounts recorded as earned but not paid, and an evaluation of the plan's success in meeting its stated goals, including controlling overall employee compensation costs.

C. Change in Federal Income Tax Rate

The Revenue Reconciliation Act of 1993 increased the federal corporate tax rate from 34 to 35 percent, retroactive to January 1, 1993. In its petition for reconsideration, the Company stated that the tax change would increase test year expense by $4.5 million for NSP Electric and by $0.4 for NSP Gas. In calculating the increase for NSP Gas, NSP used the gas utility's revenue deficiency in the Commission's September 1, 1993, Order. For the electric utility, the Company applied its requested return on equity of 12.5 percent to calculate the increase, rather than the 11 percent approved in the rate cases.

NSP stated that the change in federal tax law may be officially noticed by the Commission and applied to the rate case upon reconsideration. According to NSP, there is no need for a contested case hearing since there is no factual dispute regarding the tax change or its effect on NSP's revenues. The Company argued that failure to include the retroactive increase in rates would result in final rates which would be insufficient to recover test year expenses.

The Department had no objection to incorporating the federal tax change into the calculation of final rates. The Department did note that further legislation which would repeal the retroactive effect of the tax has been considered. If such legislation resulted in repeal of the tax during the 1993 test year, NSP should be required to refund the difference to ratepayers.

No other party commented on the Company's request to apply the federal tax change to adjust NSP's final rates.

The Commission agrees with NSP that the change in federal tax legislation should be applied when calculating the Company's final rates. This change was beyond NSP's control and will directly affect the Company's revenues. NSP has acted promptly to notify the Commission and parties of the change. It would be unfair to require the Company to absorb the decrease in net revenues, simply because the legislation did not pass until after the Company's rate cases were filed.

The Commission will apply the new federal corporate income tax rate to determine final rates for both NSP Electric and NSP Gas. The Commission will require NSP Electric and NSP Gas to refund the additional amount collected under this adjustment, should the tax be repealed for 1993.

III. ISSUES RELEVANT ONLY TO THE ELECTRIC UTILITY

A. Manitoba Hydro

1. The September 29, 1993 Order

In its initial rate case filing, NSP sought to include as test year expenses twelve months of purchased power demand charges that it will incur pursuant to a 500 megawatt (MW) participation power agreement with Manitoba Hydro Electric Board. The agreement started May 1, 1993. According to its terms, the agreement will be in effect for twelve years. Because the Company chose a test year beginning January 1, 1993, four months of the claimed expenses will occur outside the test year, i.e. between January 1, 1994 and April 30, 1994.

In its Order, the Commission rejected NSP's proposal to include these post-test year expenses on the grounds that it was contrary to Commission precedent and policy. Accordingly, the Commission reduced NSP's test year expense filing by $18,777,000, representing the out-of-test-year Manitoba Hydro expenses. This adjustment increased net income by $9,547,000.

2. NSP's Petition for Reconsideration

In its Petition, NSP acknowledged that including the four month out-of-test-year expenses pursuant to the "known and measurable" exception was at the discretion of the Commission, but argued that requiring a "compelling reason" to do so was a departure from Commission precedent. In support of this argument, the Company cited the Commission decisions regarding Northwestern Bell Telephone Company.

In addition, NSP argued that fairness requires the Commission to treat out-of-test year cost increases and decreases consistently. According to the Company, fairness would require the Commission to treat the Manitoba costs the same as it treated NSP's nuclear decommissioning costs, i.e. to take them into account.

The Company also clarified that it did not seek recovery of a full year's worth of the increased Manitoba Hydro amount during the test year, but simply requested an adjustment for final rates which would presumably be effective in 1994.

3. Commission Analysis

The Commission will deny NSP's request for reconsideration on this issue. The Company's clarification does not affect the decision. The basic issue is the same regardless of at what point rates are allowed to reflect out of test year expenses. The Commission is unpersuaded by the Company's arguments that it should exercise its discretion to allow the cited four months of out-of-test-year expenses in determining test-year operating income for rate setting purposes. The Commission's decision on this point in its FINDINGS OF FACT Order is consistent with prior Commission precedent and policy. The Commission has reexamined the reasoning presented in its FINDINGS OF FACT Order on this issue and finds that it is sound.

NSP's principal argument for reconsideration of this issue was that the Commission's decision was contrary to Commission precedent in the Northwestern Bell case. However, the facts of the Northwestern Bell case are easily distinguishable from NSP's. The test year in the Northwestern Bell case was an historical year while NSP used a fully projected test year. The Commission's willingness to go outside the test year to consider known and measurable changes hinges in large part on the nature of the test year. The nature of the test year is so important because the potential for revenue-cost mismatches is substantially greater when a projected year is used instead of an historical test year. The Commission finds that it is reasonable and consistent with past practice to use the term "compelling" to characterize the kind of reasons that must be shown to justify an out-of-test-year exception for known and measurable costs or revenues when a projected test year is used.

NSP's argument based on the alleged necessity for consistency with the decommissioning decision required a different result is also unpersuasive:

First, the eight months of Manitoba Hydro costs deemed recoverable are unlike decommissioning costs: they have actually occurred during the test year. As such, they are properly recovered through rates. On the contrary, as explained in the FINDINGS OF FACT Order at page 56, decommissioning costs have not yet been incurred and NSP will not incur them until after the shutdown of the nuclear units. In the meantime, ratepayers are supplying funds in advance of the expenditures by the Company in amounts calculated to match the expected future decommissioning costs when they occur. These amounts are properly included in rates so that adequate funds may be accumulated to meet the future costs. The FINDINGS OF FACT Order properly refers to such expenses as "unique." Order at page 57.

Second, NSP's argument that the Commission should treat the Company's Manitoba Hydro out-of-test-year costs the same way it treated the Company's decommissioning costs is difficult to follow. It would appear that the Company believes that the Commission has taken out-of test-year changes in decommissioning costs into account in calculating rates so the Commission should also consider the out-of test-year Manitoba Hydro expenses in calculating rates. The Company is mistaken. Aside from the apples/oranges difference between Manitoba Hydro costs and amounts collected to defray future decommissioning costs referred to above, the fact is that the Commission's treatment of decommissioning costs does not affect the amount the Commission has authorized NSP to recover in rates. The Order specifically rejected MEC's request for such an adjustment. Nor was a refund of amounts recovered to defray decommissioning costs ordered. Instead, NSP was simply directed to account for these amounts separately so that, in the event that the amounts collected exceed actual decommissioning costs, the Commission can take appropriate action. In short, as the Commission stated in its FINDINGS OF FACT ORDER:

> Other than adjusting the expense for the rate of return finally determined in this proceeding, the Commission does not adjust the Company's proposed test year decommissioning expense. Order at page 56.

4. Commission Action

The Commission finds no reason to alter its previous decision to exclude the four months of out-of-test-year Manitoba Hydro costs at issue.

B. Nuclear Decommissioning

1. The September 29, 1993 Order

The Commission rejected arguments to decrease test year decommissioning expenses to reflect the Company's recently filed decommissioning study in Docket No. E-002/D-93-504. The Commission also rejected arguments by MEC to reduce test year decommissioning expense by adjusting parts of the expense parameters.

The Commission did direct precautionary steps against overcollection of decommissioning funds, however. The Commission stated:

> [N]o windfall will be allowed; no amounts overcollected will be applied to offset other costs or flow to retained earnings. Due to the unique character of the expense and the uncertainties discussed above, the Commission will require the Company to deposit the amounts collected in rates for decommissioning resulting from this proceeding in the proper funds, thereby maintaining the amounts collected in a manner in which ratepayers will receive benefit of the full amounts in future decommissioning proceedings. Order at page 57.

2. NSP's Petition for Reconsideration

NSP argued that if the Commission did not change its Manitoba Hydro decision, the Commission should reconsider its decommissioning decision and permit any excess amount included in rates to be used by NSP to offset any possible increases in other costs. In the alternative, the Commission should clarify the Order to permit the tracking of decommissioning funds to prevent a windfall to the ratepayers in the event of a decommissioning cost increase.

3. Commission Analysis and Action

The Company misinterprets the Commission's Order on this issue. The Commission has not ordered a tracker account or envisioned a refund of decommissioning funds. The Commission is simply determined to give ratepayers credit for all decommissioning collections. Accordingly, the Commission has directed basic windfall precautionary measures: earmarking and proper accounting of the decommissioning funds. If greater amounts are accumulated this year, lesser amounts need be collected in the future.

The Commission finds no reason to alter its decision with respect to NSP's decommissioning funds.

C. Refuse Derived Fuel

1. The September 29, 1993 Order

In the Commission's September 29, 1993 final Order, the Commission allowed NSP recovery of costs associated with refuse derived fuel (RDF) generation. The Commission also allowed the Company recovery of capacity payments to United Power Association (UPA).

In its rate case analysis, the Commission agreed with the ALJ that the application of a prudence standard of review resulted in rate recovery. The Commission denied the requests of the Department and MAE to impose a cap on the costs of RDF-fueled generation, set at the costs of NSP's Sherco 3 coal-fired plant. The Commission also refused the intervenors' requests to disallow UPA capacity costs.

2. The Petitions for Reconsideration

In its petition for reconsideration, the Department stated that the Commission had disregarded its own 1985 Advisory Opinion in Docket No. E-002/M-84-790 when it applied a prudence standard and allowed the Company recovery of RDF generation costs. The Department contended that the 1985 Advisory Opinion, together with the possibility of ratepayer subsidization inherent in the RDF situation, demanded a modified "used and useful" standard. This standard would move away from the established definition of "useful" -- that the property be "reasonably necessary" to the efficient and reliable provision of electric service.[3] The Department's interpretation of the "useful" standard would require capping the RDF generation at Sherco 3 costs [as a proxy for qualifying facility (QF) avoided cost] to maintain ratepayer indifference.

The Department asked for Commission reconsideration to allow the imposition of capped rates. In the alternative the Department asked for clarification "[i]f the Commission has determined that it is not bound to apply the used and useful analysis for NSP's RDF costs as set forth in the 1985 Advisory Opinion..."

In its petition for reconsideration, MAE stated that NSP's RDF generation costs fail both reasonableness and prudence tests. MAE asked for either the imposition of avoided cost caps or removal of RDF facilities from rate base and establishment of a PURPA QF rate.

MAE stated that NSP's RDF generation costs are unreasonable because of the possibility of Company self-dealing and the costs of RDF's generation compared with PURPA QF costs. MAE stated that the RDF costs were imprudent because each major step that NSP took in its history with RDF was ill-advised and adverse to ratepayer interests. Finally, MAE questioned the validity of NSP's cost-benefit analysis.

3. Commission Action

a. The Department's Petition

The Department has asked for reconsideration or clarification of the Commission's RDF decision, in light of the 1985 Advisory Opinion. The Department has asked "whether the Commission has determined that it is not bound by the standard set forth in the 1985 Advisory Opinion" and "[i]f the Commission has, in fact, abandoned the 'cost competitive' standard." Review of the Commission's rate case decision and the 1985 Advisory Opinion convinces the Commission that it has not abandoned any standard, but has continued to apply the ratemaking standards found in the

---

[3] See, for example, the case cited by the Commission in its Advisory Opinion, <u>Senior Citizens Coalition of Northwestern Minnesota v. Minnesota Public Utilities Commission</u>, 355 N.W.2d 295, 300 (Minn. 1984).

1985 Advisory Opinion and a host of rate case decisions. Applying established regulatory standards, the Commission has properly found that NSP's test year RDF generation costs are recoverable in rates.

In 1984 NSP approached the Commission seeking "an order establishing Commission policy with regard to RDF related expenditures." Advisory Opinion at p. 1. NSP was considering significant investment in the new and largely untested technologies of RDF processing and electric generation from RDF-fueled facilities. NSP sought the Commission's guidance before the Company invested in all or any part of the available technologies.

The Commission responded with an Advisory Opinion which applied the established standards of "prudence and reasonableness" and "use and usefulness," as found in Minn. Stat. § 216B.16, subd. 6 and case law such as the Senior Citizens case cited by the Commission. Application of the standards cast doubt on the recoverability of investment in RDF processing. However, costs of conversion to burning RDF and of generation in RDF-fueled facilities could be considered "useful," that is, "reasonably necessary to the efficient and reliable provision of utility service." The Commission offered general guidelines to determine if investments and expenses for the modification to RDF generation would be appropriate items for ratemaking purposes. The Commission cautioned that standards of prudence and use and usefulness would ultimately be applied to determine rate case recoverability.

> The Commission also advises that under certain conditions, the burning of RDF in utility boilers could be considered "reasonably necessary to the efficient and reliable provision of utility service." In order to meet this standard, the Commission advises that at a minimum the following conditions should exist: (1) that RDF be an economically priced fuel that provides electric generation at a cost competitive with other fuels; (2) that NSP is able to secure long term contracts for the purchase of RDF; and, (3) that the burning of RDF in no way shortens plant life. Under such conditions, investments and expenses for the modification of existing NSP generating stations may be appropriate items for ratemaking purposes. However, Minn. Stat. § 216B.16, subd. 6 (1984) must be applied at the time of the rate case to determine as a matter of fact whether cost levels are prudent and whether such property is "used and useful."
>
> Advisory Opinion at p. 5.

The Advisory Opinion clearly did not break with time-honored regulatory standards of review. The factors included were offered as useful guidelines, not as a substitute for traditional analysis. There is no language in the Order which breaks with established regulatory standards to require atypical cost capping or avoided cost approach. Viewed in the context of time-tested ratemaking analysis, the word "competitive" does not require cost capping, but rather connotes a "reasonable" cost, which is the product of prudent investment and management decisions.

The Commission applied the standards of prudence, reasonableness, and use and usefulness in NSP's 1991 rate case and found that the Company's costs of RDF-fueled generation were recoverable in rates. The Commission demonstrated in that rate case and the current rate case that it had not "abandoned" any standard. Rather, the Commission continued to apply established ratemaking analysis to determine just and reasonable rates.

The Department contends that the language of the Advisory Opinion, plus the opportunity in the RDF situation for ratepayer subsidization, require a new standard of avoided cost. The Department states that it is not accusing the Company of wrongdoing -- the situation simply requires cost capping to prevent ratepayer subsidization. The Commission finds that the affiliated interest statute, Minn. Stat. § 216B.48, and the Commission's affiliated interest rules, Minn. Rules, parts 7825.1900 through 7825.2300, were drafted to allow oversight of situations such as NSP's RDF operations. The statutes and rules provide the opportunity for strict monitoring of affiliates' contracts, records, and filings. In the absence of a showing of wrongdoing on NSP's part, the affiliate statutes and rules, rather than a new method of rate recovery, should be applied to safeguard against ratepayer subsidization.

The Commission also finds that the QF avoided cost methodology is unique to the QF situation, and is not meant to be applied to general ratemaking analysis. In QF situations, a price is established which allows the QF to decide whether or not to construct its facility. That price remains stable throughout the life of the QF facility; the QF is allowed to retain any profits if its costs fall below the contract level. The QF assumes the risk of rising costs exceeding price, but is allowed to discontinue operations if the venture becomes unprofitable.

In contrast, utility operations are subject to rate of return ratemaking from plant planning and construction onward. The utility does not have a fixed price with which to make construction decisions, nor may it decide on its own to cease operations if they become less profitable. While the utility is afforded the benefit of a regulated return on its investment, cost decreases will not result in greater profit but will result in a decreased revenue requirement.

The different risks, benefits and returns of QFs and regulated utilities mean that the QF cost recovery analysis is not a generally suitable substitute for rate of return ratemaking analysis. The Commission does not find that the QF avoided cost structure should be imposed upon NSP's RDF generation.

Finally, the Commission restates that it agrees with the ALJ's analysis of the entire cost picture of NSP's RDF operations. The ALJ found that NSP's capital investments, when properly adjusted for plant life but not for capacity factors, were lower than Sherco 3's. The Commission also finds that it is improper to lump together NSP's capital investments for purposes of cost comparison; each investment decision was rational and prudent, given the facts known at the time and the investment options available.

The ALJ found that contractual incentives rendered RDF a favorable fuel, and that RDF cost benefits should be used in the overall cost analysis to determine ratepayer benefit. The Commission agrees, and disagrees with the Department that current RDF fuel benefits should not be applied because RDF was a less favorable fuel when the technology was less advanced. The Commission must look at the overall cost picture of RDF-fueled generation, and determine if the costs of such generation, as found in test year data, are prudent and reasonable. The Commission must determine if the capital investment is used and useful in the provision of electric service. Having performed these analyses, the Commission reaffirms that NSP's costs of RDF generation should be included in rates.

b. MAE's Petition

Most of the points raised in MAE's petition for reconsideration have been answered in the Commission's response to the Department's petition.

MAE requests a PURPA QF limit on the Company's RDF costs. The Commission finds that this is an inappropriate comparison between utility rate of return ratemaking and PURPA QF cost methodologies. It would require the Commission to substitute an avoided cost rate recovery method for the time-tested ratemaking prudence, reasonableness and use and usefulness analyses. There is no cause for such a change.

MAE alludes to "self-dealing" and a "conflict of interest" on the part of NSP. The Commission finds that there is no record of improper conduct by the Company. Potential ratepayer subsidization can be continually monitored under the affiliated interest statute and rules.

MAE questions the prudence and reasonableness of NSP's decisions in its initial contracts with the counties to burn garbage and NSP's failure to contract for price adjustments if pollution investments were later required. The Commission notes that the Department specifically stated that it was not challenging the prudence of NSP's RDF operations upon reconsideration. The Commission finds that there is no record evidence that the Company acted in an imprudent fashion, given the facts available to it as it made investment decisions in a new technology. NSP has met its burden of proof that it acted in a prudent fashion. The record contains adequate evidence that the overall cost picture of RDF generation does not work to the disadvantage of NSP ratepayers.

D. Unbilled Revenues

1. The September 29, 1993 Order

NSP changed its accounting practices to the accrual method for unbilled revenues as of January 1, 1992.

In the September 29, 1993 final Order, the Commission rejected the Department's request to recognize a portion of the Company's unbilled revenues as of January 1, 1992, amortized over five years.

2. Positions of the Parties

In its petition for reconsideration the Department again requested recognition of the Company's unbilled revenues for the electric utility. The Department renewed its argument that the Commission's recognition of Financial Accounting Standard (FAS) 106 transition obligation costs demands parallel recognition of the Company's unbilled revenues.

NSP stated that analysis of the FAS 106 and unbilled revenue situations must be on a case by case basis. The Company stated that the Commission had rejected arguments identical to the Department's as recently as 1992, in the Peoples Natural Gas Company rate case final Order, Docket No. G-001/GR-92-132.

3. Commission Action

The Commission finds that the Department has failed to raise new arguments regarding unbilled revenues in its petition for reconsideration. The Commission remains convinced that its treatment of unbilled revenues is just and reasonable.

The Commission finds that it is consistent in its treatment of the FAS 106 transition obligation and of the unbilled revenue balance. In the FAS 106 situation, the Commission has always found that the payment of Post-Employment Benefits Other than Pensions is a cost of service. A change in utility accounting, which results in a transition obligation, does not mean that these costs should be disallowed.

In the case of unbilled revenues, the Commission has consistently found that the balance of unbilled revenues (sometimes referred to by the Department as accumulated unbilled revenues) is not considered ratepayer property. A change in accounting to recognize this balance on utility books does not mean that the balance should now be recognized in rates. In the case of unbilled revenues, as in the case of FAS 106, utility accounting treatment does not control ratemaking treatment.

The Department's major arguments regarding the recognition of unbilled revenues have been answered by the Commission in the numerous rate case Orders cited in the Commission's

September 29, 1993 Order. The Commission will deny the Department's request to reconsider its September 29, 1993 decision regarding unbilled revenues.

E. Mandatory Time of Day Rates for Large General Service Customers

1. The September 29, 1993 Order

In the September 29, 1993 final Order, the Commission rejected the Department's request to establish mandatory Time of Day (TOD) rates. At page 106 of the Order the Commission stated:

> The Commission finds that it is inappropriate to adopt the Department's proposal for mandatory TOD rates for NSP's largest customers at this time. The Commission agrees with the ALJ that the Company should be allowed the opportunity to gain experience with the recently authorized experimental three-period TOD rate schedules.

2. Positions of the Parties

In its petition for reconsideration the Department requested that the Commission reconsider its Order and require the Company to submit a plan for implementing mandatory TOD rates in its next rate case.

NSP protested that the Commission had not yet determined if it would eventually require mandatory TOD rates, and the Company had not yet decided if it would submit a mandatory TOD rates proposal in its next rate case. To require a plan for implementing TOD rates would be inappropriate at this time.

The Metalcasters stated that it would be premature for the Commission to adopt an implementation schedule for mandatory TOD rates, in the absence of a record showing such rates will benefit NSP's ratepayers.

3. Commission Action

The Commission agrees with NSP and Metalcasters that it would be inappropriate to require the submission of a mandatory TOD implementation schedule in the Company's next rate case. Granting the Department's request to require an implementation schedule would be tantamount to reversing the Commission's original decision rejecting mandatory TOD rates. The Commission will consider the Company's TOD rates in the first rate case available for that purpose following the Company's report on the experimental TOD tariffs, due November 1, 1995. At that time, having the benefit of documentation on the Company's experimental voluntary three-period TOD tariff, the Commission will examine the full rate case record and make further determinations regarding TOD rates.

F. Interruptible Rate Design

1. The September 29, 1993 Order

In this rate case NSP proposed closing its present Peak-Controlled and Peak Controlled TOD Service schedules to new customers. The Company submitted two newly designed rate schedules which incorporated some of the concerns of large industrial customers for increased options in interruptible rates. The Department opposed the proposal, particularly the proposed level of demand charge discounts.

The ALJ found that the proposed interruptible rate design proposal was based on substantial evidence in the record, in the public interest, and appropriate for adoption. The Commission approved the Company's interruptible rate design proposal. In so doing, the Commission specifically found that there was support for the proposed demand charge discounts in the record.

2. Positions of the Parties

In its October 19, 1993 petition the Department urged the Commission to reconsider its decision and use the opportunity to establish a definitive methodology for setting interruptible rates. The Department noted that it did not object to the actual interruptible rates adopted by the Commission.

NSP stated that the Commission is currently looking at interruptible rates and other forms of rate design in NSP's pending resource plan and may want to consider an interruptible rate methodology within that context.

Minnesota Energy Consumers stated that the Department's request for reconsideration assigned no error to the Commission's decision. There is no compelling reason for the Commission to reconsider its decision.

3. Commission Action

In its rate case Order the Commission decided to approve the Company's proposed interruptible rate design, based upon substantial evidence in the record. The Department has raised no question regarding the evidence supporting the Commission's decision, and indeed states that it has no objection to the actual proposal. The Commission therefore finds inappropriate the Department's statement that adopting the proposed tariff without the Department's favored conceptual framework is "like pulling numbers out of thin air."

The Commission will deny the Department's request for reconsideration of its decision regarding interruptible rates.

G. Low-Income Rate Discount

1. The September 29, 1993 Order

In the rate case final Order the Commission rejected the RUD-OAG's proposal to establish a low income rate discount. The proposal had been supported by the Energy CENTS Coalition (ECC).

2. Positions of the Parties

In its petition for reconsideration, the ECC argued that the Commission incorrectly considered the low income discount proposal as a matter of income redistribution rather than as an opportunity to alleviate the disproportionate effect of utility costs on low income people.

The ECC argued that the Commission, rather than the legislature, is the proper forum for the discussion of low income utility discounts. The Commission should determine the equity of each utility proposal on a case by case basis. NSP should be required to implement a discount mechanism to replace the phased out Conservation Rate Break. Finally, the low income discount rate is the best means of leveraging state and federal funds to energy assistance.

In its oral arguments before the Commission, the ECC requested the Commission to call together a collaborative to examine NSP's low income discount proposal.

The RUD-OAG urged the Commission to examine on a case by case basis each utility's efforts to address the needs of its low income customers. The RUD-OAG argued that the Commission does not need legislative guidance or direction for this policy determination. The agency urged the Commission to use this opportunity to leverage additional federal dollars to state energy assistance programs.

3. Commission Action

A rate design decision regarding a utility's low income assistance is clearly a policy determination which falls within the Commission's legislative mode of decision making. In this case, the parties have not introduced new evidence or arguments which convince the Commission to reconsider its policy decision.

The Commission recognizes the genuine concern for low income Minnesotans displayed by the ECC and the RUD-OAG. The Commission shares this concern. The Commission, however, must discharge its duty to analyze rate design proposals in a manner which promotes the goal of just and reasonable rates for all ratepayers. The current low income discount proposal does not fulfill this goal. As the Commission stated in its rate case final Order, NSP is "not uniquely responsible for subsidizing the energy consumption of low income citizens, above and beyond the responsibility borne by other citizens of the State of Minnesota." Order at p. 94.

The Commission continues to look to the legislature for an equitable statewide utility energy assistance policy.

III. ISSUE REQUIRING CLARIFICATION BETWEEN THE RATE CASES

A. Purchasing and Contracting

1. The Rate Case Orders

Parties raised concerns regarding NSP's purchasing and contracting practices in both the gas and the electric rate cases. The Department questioned the Company's policies of competitive bidding for goods and services.

In the September 1, 1993, gas rate case final Order, the Commission ordered the Company to file a report on its purchasing practices and procedures within six months of the date of the Order. The Company was told to work with the Department in setting the criteria for the report.

In the September 29, 1993, electric rate case final Order, the Commission directed the Department to analyze NSP's purchasing practices, beginning with the Company's Purchasing Department Policy and Procedure Manual. The Commission ordered the Department to report on NSP's policies, procedures and compliances within six months of the date of the Order.

2. Positions of the Parties

In its petition for reconsideration the Department requested that the Commission reconsider its Order in this case and order NSP to file a single report for both utilities, with the Department and the Company working together to delineate the contents and criteria for the report.

The Company agreed that a single report was appropriate, but requested that the Department prepare the report.

3. Commission Action

This issue was decided in the gas rate case ORDER AFTER RECONSIDERATION. At page 13 of that Order, dated December 30, 1993, the Commission stated:

> The Commission will require the Department to report on the Company's purchasing policies, procedures, and compliance within six months of the date of this Order.

The Department will therefore prepare a single report, which will be due on or before six months from December 30, 1993.

IV. RATE BASE SUMMARY

After reconsideration, the Commission concludes that the appropriate rate base for the test year is $2,373,766,000 as shown below (000's omitted):

Utility Plant in Service	$5,221,399
Less: Reserve for Depreciation	2,408,086
Net Utility Plant in Service	$2,813,313
Construction Work in Progress	141,327
Plant Held for Future Use	0
Accumulated Deferred Income Taxes	(590,859)
Working Capital	
Cash Working Capital	(78,044)
Materials and Supplies	86,729
Fuel	25,486
Prepayments	6,803
Other	(30,989)
TOTAL AVERAGE RATE BASE	$2,373,766

V. OPERATING INCOME STATEMENT SUMMARY

After reconsideration, the Commission concludes that the appropriate Minnesota jurisdictional operating income for the test year under present rates is $178,685,000 as shown below (000's omitted):

Operating Revenues:	
Retail Revenues	$1,331,822
Unbilled Revenues	4,852
Other Operating Revenues	162,474
Gross Earnings Taxes	23,345
Total Operating Revenues	$1,522,493
Operating Expenses:	
Production	$ 619,175
Transmission	33,155
Distribution	73,078
Customer Accounts	28,477
Customer Information	10,407
Administrative and General	137,463
CIP/DSM Amortization	21,239
Other Expense	3,788
Depreciation and Amortization	186,863
Taxes:	
Real Estate and Property	130,561
Gross Earnings	23,345
State and Federal Income	83,947
Deferred Income	(17,721)
Other	16,436
Total Operating Expenses	$1,350,213
Operating Income Before AFUDC	$ 172,280
AFUDC	6,405
Operating Income With AFUDC	$ 178,685

VI. GROSS REVENUE DEFICIENCY

After reconsideration, the Minnesota jurisdictional gross revenue deficiency is $72,169,000 as shown below (000's omitted):

Rate Base	$2,373,766
Rate of Return	9.31 %
Required Operating Income	$ 220,998
Test Year Net Operating Income	178,685
Operating Income Deficiency	$ 42,313
Revenue Conversion Factor	1.705611
Gross Revenue Deficiency	$ 72,169

After reconsideration, the Commission found total Minnesota jurisdictional revenue at present rates of $1,522,493,000. Adding the gross revenue deficiency of $72,169,000 to this amount results in total authorized Minnesota jurisdictional revenue of $1,594,662,000.

ORDER

1. Rate recovery of the costs of the incentive compensation plan shall be limited to 2.2 percent of total base salary costs, with individual payments not exceeding 15 percent of the individual's base salary, and corresponding pension costs.

2. The Company shall record for future refund all incentive compensation payments earned under the terms of the plan and recoverable in rates under this Order but not paid.

3. The Company shall file a report on or before April 1, 1995 and annually thereafter evaluating the operation and performance of its incentive compensation plan. The report shall include, but shall not necessarily be limited to, an accounting of all amounts paid under the plan, an accounting of all amounts recorded as earned but not paid, and an evaluation of the plan's success in meeting its stated goals, including controlling overall compensation costs.

4. The return on equity for NSP is 11.47 percent, which combined with other factors results in an overall rate of return of 9.31 percent, calculated as shown in the body of this Order.

5. NSP's final electric rates, similar to its final gas rates, shall be adjusted to reflect the increase in the federal corporate income tax rate from 34 to 35 percent, retroactive to January 1, 1993. If this federal tax change is repealed retroactive to 1993, NSP shall refund the amount collected which reflects the increase from 34 percent.

6. On or before six months from the issuance of the Commission's ORDER AFTER RECONSIDERATION in NSP's gas rate case, i.e. six months from December 30, 1993, the Department shall submit a report on NSP's purchasing policies, procedures, and compliance.

7. In all respects not identified in the foregoing paragraphs, the Commission's September 29, 1993 FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER in this matter remains unaltered.

8. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Burl W. Haar
Executive Secretary

(S E A L)

DISSENTING OPINION

Commissioners Kitlinski and Knaak, dissenting

On September 29, 1993, the Commission issued its FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER in the NSP Electric rate case, which included issues common to the Company's gas and electric rate cases. In that Order, the Commission set NSP's rate of return at 11.0% and disallowed recovery of the full amount of incentive compensation costs sought by the Company. The Commission's findings and conclusions on these issues were well reasoned and grounded firmly in the evidence presented.

In the short time between its initial decision and reconsideration in this case, the majority has seen fit to change its decision on these two critical issues. The majority did not have the benefit of new evidence or arguments; yet it revised two fundamental decisions that had been made after months of review and days of argument and deliberation. This, in our view, exceeds the limits of the appropriate use of reconsideration. We must, therefore, respectfully dissent.

The Commission has used reconsideration very judiciously in the past, rarely changing its findings or conclusions except to correct obvious technical errors which come to light after the original Order has been issued. Absent the introduction of significantly new and persuasive arguments, the Commission should continue its tradition of restraint and not cast aside major decisions made after long and careful consideration. Failure to limit the scope of reconsideration in this way renders the Commission's initial Order something approaching a rough draft which, upon brief reflection, becomes subject to major revision. Reconsideration becomes a forum to rehash old arguments and rethink well-considered findings and conclusions.

The Commission's proceedings were never intended to operate in this manner. The Commission's Orders are generally expected to be final and the availability of reconsideration should not suggest otherwise. In this case, the majority's change of view on reconsideration will cost NSP's electric customers approximately 14 million dollars annually; it will cost gas customers some 1.3 million dollars per year. The Commission's September 29, 1993 Order set out a very detailed and compelling case for an 11.0% rate of return and for disallowing the full amount of the Company's incentive compensation costs. The Commission should have reaffirmed those decisions here.

Signed ____________________________________
Cynthia A. Kitlinski
Commissioner

Date: ____________________________________

Signed ____________________________________
Dee Knaak
Commissioner

Date: ____________________________________